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FROM THE AMBASSADOR FOR H FOR CODEL BEAN AND EUR/SCE

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SUBJECT: SCENESETTER FOR CODEL BEAN'S VISIT TO BELGRADE

1. Representative Bean,

Your delegation is visiting Serbia at a time when local leaders are confident about the success so far of Serbia's policies on Kosovo and progress in integration with the European Union. In reality, the current Kosovo status delay is no more sustainable than the status quo in Kosovo itself and the government here is doing little to prepare for inevitable independence. Despite its sharp, single minded rhetoric over Kosovo, Serbia's government faces even more difficult choices in the near future if the country is to close out finally the Milosevic era and achieve full integration with Europe and continued partnership with the United States. There is a dire need for creating better living conditions for Serbians, for more economic and democratic reform, full ICTY cooperation, and signature of a Stability and Association Agreement with the EU.

Economic Situation

12. Serbia's economic outlook has improved significantly over the past years; first-quarter growth accelerated to 8.7 percent this year, from 6.5 percent for 2006. The National Bank's movement toward inflation targeting has been successful in holding inflation to 5 percent in the year ending in May, while the dinar, Serbia's currency, has appreciated in value. However, many analysts worry now that expansionary fiscal policy, with a projected 2007 budget deficit of roughly 3 percent of GDP by IMF standards, is causing the economy to overheat, with rapid import growth leading to an increase of 35.4 percent in the trade deficit over the first five months of 12007. Standard and Poor's just downgraded Serbia's outlook from positive to stable based on fiscal relaxation.

13. Revitalization of Serbia's real sector is generally considered the answer both to the increasing current account deficit and high unemployment. Joblessness stands at roughly 21 percent. Privatization so far has yielded good results, with exports up 39.8 percent the first five months of the year. However, the reluctance of the previous government to bankrupt unsaleable companies means that the hard work is still ahead; some 1,200-1,300 socially-owned companies still await privatization or bankruptcy. In addition, the Government has plans to privatize, or partly privatize, major state-owned enterprises such as copper mine RTB Bor, state airline JAT and petroleum company NIS. Deputy Prime Minister Djelic recently said that the Kostunica government will not privatize Telekom Srbija nor power company EPS during its mandate. Greenfield foreign direct investment (FDI) is critical to generate jobs; measures to attract FDI include tax incentives, direct subsidies on a per-job basis and projected construction of industrial parks.

14. Serbia has benefited by generous donor assistance since the fall of Milosevic in October, 2000, including USD 617.49 million in SEED funding. SEED funding of USD 60 million for 2007 has been allocated primarily (80 percent) to economic development activities and job

creation. A three-year Extended Arrangement with the International Monetary Fund ended in February, 2006, with total disbursements of USD 937 million dollars; completion of the IMF agreement also released the final installment of Paris Club debt relief, by which about two-thirds of Serbia's official debt was written off. The World Bank continues to be active in Serbia; on June 20, it approved USD 192.5 million in additional lending, with projects for redevelopment around an impoverished area of Eastern Serbia, agricultural development, irrigation, road repair and energy efficiency. The EU has provided EUR 2.56 billion (to Serbia, Montenegro and Kosovo) since 2000; another EUR 572.4 million for Serbia over 20007-2009 is projected as part of the EU's pre-accession assistance.

Political Landscape

15. Serbia's January 2007 parliamentary elections returned a majority to democratic parties but also saw the ultra-nationalist Serbian Radical Party (SRS) make the strongest individual showing (81 of 250 seats). Democratic bloc winners included Boris Tadic's Democratic Party (DS - 64 seats), Vojislav Kostunica's Democratic Party of Serbia (DSS - 47 seats), and Mladjan Dinkic's G-17+ (19 seats). Turnout for the elections itself was unexpectedly high, and led to some surprise parties gaining seats. Notably, the Socialist Party (SPS) formerly headed by Slobodan Milosevic managed to earn enough votes to cross the threshold and remain in parliament, as did a reformist coalition of small parties led by the Liberal Democratic Party. Four different minority groups also gained seats - Hungarians, Bosniaks, Roma, and - for the first time in over a decade - Albanians from Southern Serbia.

16. Coalition negotiations were launched in earnest in early February, 2007, and culminated in a last-minute deal between the DS

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and DSS following the latter's brinksmanship tactic of unanimously endorsing Radical leader Tomislav Nikolic for the post of Speaker of Parliament. The resulting coalition agreement leaves DS with a majority of cabinet seats (13 of 25) including Foreign Affairs, Finance, Justice, and Defense, but cedes to DSS the post of Prime Minister, the Interior Ministry, and the state security service (BIA). The agreement also resulted in the formation of a new Ministry for Kosovo headed by the DSS which has quickly established procedures to control all aspects of the government's Kosovo policy - often at the expense of other ministries.

17. Today, two months into the new coalition, the main parties appear to have struck a balance in their areas of responsibility -- the DSS is handling Kosovo and the DS is handling ICTY and the defense sector. Both sides at the same time are pushing on EU accession and project hard line public rejection of Kosovo independence. SAA talks were suspended in May 2006 due to lack of ICTY cooperation, and were resumed in June 2007 acknowledging that the new government had met some of its commitments. Two of the final six war crimes indictees -- Tolimir and Djordjevic -- were arrested in June 2007 (in Bosnia and Montenegro, respectively) and sent to The Hague during the first weeks of new government's tenure. However, the European Commission insists that it will not sign the SAA agreement without increased cooperation with the Hague Tribunal, i.e., capture of Bosnian Serb fugitives Radovan Mladic and Radovan Karadzic.

18. The two opposition blocs, meanwhile, have competing aims. The hardline nationalist Radical and Socialist parties snipe at the government and join in maintaining an increasingly rigid Kosovo policy, but have otherwise been remarkably silent about the new government and its performance. The uproar over the recent ICTY arrests was far more muted than expected. The democratic opposition of the Liberal Democrats, however, has focused its attacks on what it considers a backward-looking Kosovo policy and inadequate attention paid to the Serbian people's every day concerns.

Kosovo: The View from Belgrade

¶9. In his visit to the region in June, the President made clear USG's policy that Kosovo will be independent following over 15 months of UNSC-sanctioned negotiations. Shortly thereafter, French President Sarkozy also noted that independence for Kosovo was inevitable. As of July 2007, the UNSC has not reached an agreement on the Ahtisaari plan, or any other resolution to supersede UNSCR 1244, and Kosovo still technically remains in Serbia. Assistant Secretary of State Fried announced in mid-July that the USG will

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support a new round of talks between the leaders in Belgrade and Pristina, while keeping in mind the positions clearly stated by the President and his French counterpart.

¶10. The Government of Serbia, which had agreed with the concept and structure of the UN-led talks, failed to fully engage and in fact, relentlessly attacked both the process and mediator (Martti Ahtisaari). The GOVERNMENT OF SERBIA has since rejected Ahtisaari's proposal and any UNSC draft based upon it; Belgrade insists on starting over completely with a new round of talks that exclude the option of Kosovo independence and without a defined end.

¶11. PM Kostunica believes unity among EU members and the USG to implement the Ahtisaari Plan as quickly as possible has been dissolved. Kostunica depends on Russian support to keep the Plan from being approved by the UNSC. Serbia's new Kosovo Ministry -- headed by the Prime Minister's close advisor Slobodan Samardzic -- aims to coordinate the various ministries' with relevant issues (Defense, Foreign Affairs, Interior) on Kosovo and also manage any engagement with the international community. DS officials including President Tadic, Foreign Minister Jeremic and others do not differ from the PM's comments on Kosovo. All Serbian leaders categorically reject Kosovo independence and the Ahtisaari plan, and believe their EU accession will not be slowed by a lack of resolution on the Kosovo status issue. Rhetoric against the U.S. position on Kosovo has continued to escalate in recent weeks, calling our position cowardly and illegal, and our assertions of friendship with the Serbian people an insult to common sense. The government leadership has threatened serious consequences for relations between Serbia and any country that recognizes an independent Kosovo.

¶12. We look forward to receiving you and your delegation in Belgrade during this challenging time.

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